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IN THE

Supreme Court of the United States

OCTOBER TERM, 1959

No. 463

WILLIAM K. WARREN and NATALIE O. WARREN, ET AL.,
Petitioners,

v.

THE UNITED STATES, *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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The taxpayers pray that a writ of certiorari issue to review the judgment of the United States Court of Claims, entered on April 8, 1959. Motion for a rehearing was overruled on July 13, 1959, (Appendix A, *infra*, p. 1a)

OPINION BELOW

The opinion of the United States Court of Claims is not yet reported officially but is reported unofficially at 171 F. Supp. 846. Both the majority opinion (Madden, Judge) and the dissenting opinion (Jones, Chief Judge) are printed as Appendices B and C, respectively, *infra*, pp. 2a, 8a.

JURISDICTION

The judgment of the Court of Claims was entered on April 8, 1959. A motion for a rehearing and for relief from the order of the court was filed on May 8, 1959, and was overruled on July 13, 1959, (Appendix A, *supra*). Review by petition for a writ of certiorari is sought pursuant to the provisions of 28 U.S.C. 1255(1).

QUESTION PRESENTED

All of the petitioners were stockholders of a corporation which was liquidated in 1941. Each petitioner was to receive in liquidation a certain amount of cash in 1941, plus an overriding royalty contract providing for future payments. The trial commissioner of the Court of Claims who heard the evidence found that the overriding contracts had no ascertainable fair market value when received in 1941.

In later years, 1949 to 1952, inclusive, the petitioners received deferred payments under those contracts, and the question is whether such deferred payments are taxable at capital gains tax rates or at ordinary income tax rates.

STATUTE INVOLVED

The statute involved is the Internal Revenue Code of 1939, sections 111, 112, 115 and 117, which are set forth in Appendix D, *infra*, p. 12a.

STATEMENT

All of the petitioners were stockholders of The Corpus Christi Corporation which liquidated in 1941. For their stock each received cash (not in dispute) plus an overriding royalty contract entitling

them to possible future payments. For 1941, the petitioners did not treat the overriding royalty contracts as income. They stated in their returns that such royalty interests had no ascertainable fair market value. Thereafter, the Commissioner of Internal Revenue determined that the overriding royalty contracts had a value of $1,035,000, in 1941, and after the stockholders had received this amount any sums received thereafter were taxable as income at ordinary rates. The petitioners acquiesced in this determination through the taxable year 1948, but filed claims for refund for 1949 to 1952, inclusive, on the ground that the determination of the Commissioner was erroneous and that amounts received by petitioners should have been taxed at capital gains rate.

As required in Section 6532 (a)(1) of the Internal Revenue Code of 1954, these claims either had been rejected by the Commissioner of Internal Revenue or had been filed more than six months prior to the institution of these suits in the Court of Claims. In the majority opinion of April 8, Appendix B, *supra,* the Court of Claims sustained the action of the Commissioner of Internal Revenue. In the trial before the Court of Claims the trial commissioner found that:

> "* * * it was impossible to determine the value of such royalties with reasonable accuracy * * *" (Finding No. 32(a) to (h) inclusive.) [R-53, 54]

The majority opinion, Appendix B, *supra,* states:

> "As to the controverted question of whether the plaintiffs' overriding royalties were, in 1941, reasonably susceptible of valuation, we have concluded that the question need not be answered. * * *"

Chief Judge Jones, in his dissenting opinion, Appendix C, *supra*, stated:

> "* * * Where the factors affecting the valuation are so uncertain, contingent, or speculative that the value cannot be determined with reasonable accuracy, it must be held that the oil and gas interests have no fair market value. That is the situation here as found by the trial commissioner who heard and considered all the evidence bearing on the question. The reasons for this finding of lack of any market value at the time of the transfer are set out in findings 30, 31, and 32. For some reason the majority has seen fit to eliminate these findings."

REASONS FOR GRANTING A WRIT

The majority opinion below, which involves an important issue as to how the proceeds from a contract having no fair market value are to be treated as income for tax purposes, is in direct conflict with the ruling of the Court of Appeals for the Second Circuit in *Commissioner* v. *Carter*, 170 F. 2d 911 (Appendix E *infra*, p. 14a), and the ruling of the Court of Appeals for the Ninth Circuit in *Westover* v. *Smith*, 173 F. 2d 90 (Appendix F, *infra*, p. 19a), as well as with various decisions of the U. S. Tax Court; one of the latest being *Hoy* v. *Commissioner*, 17 T.C.M. 115 C.C.H.—T.C.M. 1958-28.[1] The conflict is one of continuing importance under various revenue acts, and widespread litigation will continue until the point is settled by this Court.

(1) As appears on its face, the decision below is in direct conflict with the Second Circuit's decision in

[1] The *Carter*, *Westover* and *Hoy* cases cited and relied upon *Burnet* v. *Logan*, 283 U.S. 404, as being the basis of the **open transaction doctrine** discussed, *infra*, p. 9.

Commissioner v. *Carter*, *supra*. In *Carter*, the taxpayer had owned for ten years all the stock of the corporation which was dissolved in 1942. Upon dissolution of the corporation, all of its assets were distributed in kind. In the distribution, the taxpayer received property having a fair market value in excess of $20,000.00 over the cost basis of her stock, and she reported such excess as a capital gain in her 1942 return and paid tax thereon. In the liquidation she also received 32 oil brokerage contracts which had no ascertainable fair market value when distributed. In 1943, the taxpayer collected commissions of $34,992.20 under the contracts which she reported as a long-term capital gain. The Commissioner determined it to be ordinary income. The Tax Court held it taxable as capital gain, and the Court of Appeals affirmed. Said the Court:

> "The Commissioner argues that the *Logan* case is inapplicable because there the taxpayer had not recovered the cost basis of her stock while here she had. The Tax Court thought the distinction immaterial. We agree. The Supreme Court spoke of the annual payments as constituting "profit" after the seller's capital investment should be returned. Until such return it cannot be known whether gain or loss will result from a sale; thereafter it becomes certain that future payments will result in gain. No reason is apparent for taxing them as ordinary income. As this court said in *Commissioner of Internal Revenue* v. *Hopkinson*, 2 Cir. 126 F. 2d 406, 410, 'payments received by the seller after his basis had been extinguished would have been taxable to him as capital gains from the sale of the property', citing *Burnet* v. *Logan* as authority."

(2) The decision of the Ninth Circuit in the *Westover* case is in accord with the *Carter* case. In *Westover*, the taxpayer owned all the stock of the Quickwork Company, a corporation engaged in the manufacture and sale of machine tools. In 1940, the corporation sold all of its assets in exchange for cash and the right to receive 10 percent of the gross sales price of machinery to be manufactured by the purchaser. The Quickwork Company was thereupon liquidated. The distribution in liquidation netted the taxpayer $39,204.26 in cash and the contract calling for 10 percent of the gross sales made by the purchaser. The adjusted basis of the stock to the taxpayer on the date of liquidation was $34,000.00, and she paid a capital gain tax on the $5,204.26 profit. Payments received by the taxpayer in subsequent years were treated by the Commissioner as ordinary income. The taxpayer contended that the receipt of the 10 percent of the gross sales price of the machinery actually manufactured under the contract was an integral part of the liquidation-distribution and therefore such sums were to be treated as payments in exchange for stock. The court found that the contract had a very substantial value but there was no way of ascertaining its fair market value. The court, in holding for the taxpayer, stated:

> "* * * The payments in this case arose directly out of the contract, which had a substantial value, and may be said to be 'amounts distributed' within the purview of § 115(c), thus falling squarely within the holding in Burnet v. Logan, 283 U.S. 404, 51 S. Ct. 550, 75 L.Ed. 1143. Distributions under § 115(c) are treated in the same manner as sales. In any event, it is clear that the contract itself was a distribution under § 115(c). Its tax-

able valuation is its fair market value, according to § 111(b) of the Internal Revenue Code. *Although there was no ascertainable fair market value at the time of liquidation, we find nothing in the statute requiring the market value to be measured immediately. In such a situation the only practicable and accurate method of measuring the contract's value is through the application of money to such valuation as it is received.* The alternatives are to ascribe a fictitious or speculative value to the property, which was condemned in the Logan case, or to allow it no value, as urged by appellants. Such methods result in inaccuracies and inequities. We think the proper procedure is to measure the value of the contract as payments are received." (Emphasis added)

(3) The Tax Court has consistently adhered to the same ruling. In fact, as late as 1958, it treated the question in a memorandum opinion, *Hoy* v. *Commissioner*, 17 T.C.M. 115, C.C.H.-T.C.M. 1958-28.

In *Hoy*, the taxpayer owned all the stock of Hoy Equipment Co. This Corporation had a contract whereby it was to receive a royalty of 10 percent on all sales of ham molds and loaf molds, etc., made by The Globe Company. On July 31, 1950, the Hoy Equipment Co. was dissolved and liquidated and Hoy received all the assets and assumed the liabilities. Among the assets was the 10 percent royalty contract with Globe. Globe paid Hoy royalties in 1951, 1952 and 1953 the amounts of $29,685.41, $32,844.09, and $32,401.94, respectively.

The Commissioner had found a value for the contract on July 31, 1950, of $123,638.85, and that the amounts subsequently received by Hoy in excess

of that were taxable as ordinary income. On appeal to the Tax Court the taxpayer contended that under the *Logan*, *Carter* and *Westover* cases the royalties received thereafter were additional capital gains from the liquidation.

The Tax Court found that the value of the contract with Globe on July 31, 1950, was not ascertainable, sustained the taxpayer and entered a decision accordingly. No appeal was taken by the Commissioner. Said the Court:

> "The petitioners contend that the value of the Globe contract was not ascertainable on July 31, 1950, and that, pursuant to *Burnet* v. *Logan*, 283 U.S. 404 (1931) [2 USTC ¶ 736], the royalties received thereafter were additional capital gains from the liquidation. This rule has also been applied in *George J. Lentz*, 28 T. C. 1157, [Dec. 22,567]; *J. C. Bradford*, 22 T.C. 1057, (1954) [Dec. 20,511]; *Susan J. Carter*, 9 T. C. 364. (1947) [Dec. 16,015] aff'd 170 Fed. 2d 911 (C.A. 2, 1948) [48-2 USTC ¶ 9415]; and *Westover* v. *Smith*, 173 Fed. (2d) (C.A. 9, 1949) [49-1 USTC ¶ 9189].
>
> * * * *
>
> "There were a number of factors tending to make uncertain any forecast of the sums to be realized from the contract. It was dependent upon future production and sales by a company over which Hoy had no control. It depended upon the extent Globe would utilize the patents which were principal factors in Hoy's business, but only a part of Globe's interests. It was uncertain whether competition or new inventions would depress the sales volume or render the products obsolete. Globe used heavier gauge steel and increased the life of the molds which made replacements less frequent. Hoy believed that employment of De Cressy by Globe was important to main-

tain sales and was willing to pay him a part of the royalty to stay, but it was uncertain how long De Cressy would remain with Globe. In fact he left that employment in 1951. It could not be known whether the parties might agree to reduce the royalty as provided in the contract. Such a reduction did occur in 1955. In view of these uncertainties the valuation proposed by the respondent is, in our opinion, too speculative to stand. We find that the fair market value of the contract was not ascertainable on July 31, 1950."

(4) The decision of this court in *Burnet* v. *Logan*, 283 U.S. 404, is not reconcilable with the opinion below. That case laid down the rule that property has no fair market value when it cannot be valued with a reasonable degree of accuracy; further, that royalties received under a contract having no fair market value are not to be taxed until the taxpayer has recovered his tax basis in the property he sold. In so holding, the Supreme Court established the foundation stone of the **open transaction doctrine** under which a taxpayer is entitled to capital gains treatment on the proceeds subsequently received from a contract having no fair market value when transferred to the taxpayer in exchange for a capital asset. In that case the taxpayer, as part of the consideration for the sale of stock, received a 1/16th interest in a royalty contract providing payment of sixty cents a ton on iron ore to be mined under a 97 year lease from certain property. The Court, in holding that the royalties had no fair market value, stated:

"* * * When the profit, if any, is actually realized, the taxpayer will be required to respond. The consideration for the sale was $2,200,000.00 in cash and the promise of future money payments wholly

> contingent upon facts and circumstances not possible to foretell with anything like fair certainty. The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one."

The **open transaction doctrine** is well recognized by the Commissioner of Internal Revenue, as shown in Revenue Ruling 58-402,IRB 1958-33, 8, 9, which reads in part as follows:

> "The results, for purposes of capital gains or ordinary income, are that if the sale or exchange remains an open transaction, because of unusual uncertainties with respect to valuations in rare and extraordinary cases, then the subsequent payments received under the contract will be subject to the appropriate capital gains provisions in the statute; * * *"

Doubtless the Commissioner's publication of the foregoing portion of the ruling was occasioned by the numerous court decisions following the open transaction doctrine. (See Appendix G, *infra*, p. 23a, listing 43 such cases.)

Obviously, in such a situation as is now before the Court, it takes little imagination to conclude that the amounts received were from an open transaction and that the gain thereon was a capital gain.

This is not a depletion case as argued by the Government below. The sole issue is whether the proceeds received from the sale of a capital asset are to be taxed at capital gains rates, as we contend, or at ordinary income rates, as the majority opinion below held. There should be no exception to the open trans-

action doctrine or to the principles of the *Logan*, *Carter*, *Westover* or *Hoy* cases, on the ground that in the instant case the taxpayers had a property or "economic interest" in the overriding royalties. Clearly, in the *Logan* case the taxpayer had a property or "economic" interest in the iron ore royalties from a 97 year lease. Certainly the taxpayers had the same type of interest in the properties involved in *Carter*, *Westover* and *Hoy*.

CONCLUSION

In addition to the conflict between the U. S. Court of Claims in the instant case and the Courts of Appeals for the Second and Ninth Circuits, and the cases of the Tax Court and other pending cases, the question involved is one of substantial importance in the administration of the Revenue Laws. This petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

UNITED STATES COURT OF CLAIMS

Nos. 73-55 and 272-55

WILLIAM K. WARREN, ET AL

v.

THE UNITED STATES

Clerk's Office
Washington, D. C., July 13, 1959

To Attorney of Record and Assistant Attorney General, and Commissioner .....

Sirs:

Please take notice that in the above-entitled cause there has been entered this day on the plaintiff's motion for rehearing and for relief the following order:

Overruled.

Very truly yours,

WILLARD L. HART
Clerk, Court of Claims.

APPENDIX B

[Heading Omitted]

OPINION

MADDEN, *Judge*, delivered the opinion of the court:

The plaintiffs sue for the refund of a part of the income taxes paid by them for the years 1949 through 1952. They paid their taxes for these years on the basis that the income in question was ordinary income. Their claim in these suits is that the income was long-term capital gain, taxable at a lower rate.

In 1938 the Corpus Christi Corporation was organized under Texas law to acquire and develop oil and gas properties in some 8,782 acres of land in three counties in Texas. Of Corpus Christi's 5,000 shares of stock, The Chicago Corporation owned 1,250 and the other 3,750 were owned by the plaintiffs and other persons.

By May 5, 1941, some 18 producing wells had been brought in on about 2,200 acres of the property. The other 6,000 acres of the land had not been tested. A high-pressure recycling plant had been constructed to extract the saleable distillate from the wet gas and reinject the dry gas into the earth to exert pressure on the wells. The necessary financing to continue and expand the development of the property was a problem to the plaintiffs and they sought to dispose of their stock in Corpus Christi. They negotiated with a number of individuals and corporations, including Chicago, which, as we have seen, already owned 20 percent of the stock of Corpus Christi. Chicago offered to buy the stock of the other shareholders, if it could get enough of it so that it would hold at least 80 percent of the stock, the minimum amount required under Texas law to enable it to liquidate the corporation, and under section 112(b)(6) of the Internal Revenue Code of 1939 to accomplish the liquidation of a corporate subsidiary tax free. Chicago was to pay the selling shareholders $163.63 per share, plus an additional specified cash amount if the liquidation turned

out to be, in fact, tax free. In addition, Chicago, agreed to convey to each shareholder who sold his stock to Chicago, an "overriding royalty" in the oil, gas and other products of the Corpus Christi leases. In the gas and oil industry, an "overriding royalty" means a fraction of the working interest which by agreement is relieved of the expense of the development and production.

The sale of the Corpus Christi stock was accomplished and Corpus Christi was liquidated. In general terms the situation was, then, that the land owners who had made the leases to Corpus Christi had a royalty interest in the mineral products produced, presumably a one-eighth royalty interest, Chicago had the "working interest," presumably seven-eighths, which had formerly belonged to Corpus Christi, less the "overriding royalty" which Chicago had in the purchase of stock transaction, conveyed to the selling stockholders.

This small overriding royalty owned by the plaintiffs was, under Texas Law, a property interest, *Rogers National Bank of Jefferson* v. *Pewitt*, 231 S.W. 2d 487, and was recorded in the land records of the appropriate counties. In the agreement between Chicago and the plaintiffs creating the overriding royalty in the plaintiffs, Chicago, as the holder of the working interest in the leases, agreed to pay all the expenses of development, operation and exploration, and to diligently prosecute these activities. The plaintiffs had the right to take their share of the product in kind, or to give "division orders" to Chicago to sell their share of the products for their account and pay the money over to them. During all of the times pertinent in this suit such division orders were in effect.

In the plaintiffs' tax returns for 1941, the year in which they sold their Corpus Christi stock to Chicago, they reported as long-term capital gain the excess of the cash paid them by Chicago over what their Corpus Christi stock had cost them. They did not include in their capital gain

any value for the overriding royalties which they received in the transaction, stating that those interests had no ascertainable market value. The taxing authorities, however, placed a value of $1,035,000 upon those interests of all the minority stockholders, and added proportionate parts of that amount to the capital gains of the plaintiffs. Presumably they paid taxes on these additional amounts of capital gain.

The properties proved highly productive. From July 1, 1941 to the end of 1956 Chicago remitted to the plaintiffs and the other former stockholders $11,548,107.84 as the amount of the proceeds of their overriding royalty share of the products.

For the taxable years 1949 through 1952 here in question, the plaintiffs included, in their returns, their receipts from their royalty interests as ordinary income subject to the statutory 27½ percent depletion allowance. So far as appears, they had also treated that income similarly for the years 1941 through 1948. For the years 1949 through 1952 they filed timely claims for refund on the ground that the receipts from their overriding royalties were additional amounts received by them as a part of the price of their sale of their Corpus Christi stock to Chicago in 1941, and should, therefore, be taxed at capital gains rates.

When the plaintiffs sold their Corpus Christi shares to Chicago in 1941 they, as we have seen, received some cash, a promise of some more cash if the purchaser was not required to pay a tax on its profit made out of the liquidation of Corpus Christi, and the "overriding royalty" in the oil and gas. This last item was, as we have seen, a property interest. If it had been a more normal, more tangible kind of property, its value would as a matter of course have been added to the cash received and the plaintiffs' gain would have been computed on the combined figure. If, although the property interest received was of an unusual nature, such as an overriding royalty, it had

a market value which could be reasonably estimated, the same computation would be made. If such an estimation was made by the taxpayer, and the Government agreed to it, and the capital gain tax was paid on that basis, that would end the capital gain matter for that transaction, subject, presumably, to whatever rights the statutes give to either the taxpayer or the Government to reopen it within prescribed periods.

If the matter was closed in the manner just indicated, the subsequent tax treatment of the newly acquired property would be normal. If the property produced income, such as rent, the rent would be taxed as such. If, as an interest in oil or gas property, it produced oil or gas or the income from the sale of those minerals, the income would be taxed, after the deduction of the statutory depletion allowance.

The plaintiffs say that these normal consequences of the sale of property do not obtain in the instant case because the "property" which the Government says the plaintiffs received in the transaction with Chicago was not, they say, reasonably susceptible of valuation at the time they received it. The fact that the Government valued the overriding royalties of all of the holders of such interests at $1,035,000 in 1941, and the holders received, in the next fifteen years alone, $11,548,107.84 shows that the estimated value was a rough and inaccurate guess.

The plaintiffs say that whatever money they got in, as a consequence of the sale of their Corpus Christi stock, was a part of the sale price, though its receipt was unanticipated and delayed. If, as one item of consideration for the sale of property, the seller took in an empty apartment building in a ghost town, the building having a negligible market value, and shortly thereafter because of the location by the Government of an atomic or other large project in the area, the apartment building became a gold mine of income, the owner could truthfully say that the income was a consequence of his sale of his property and his receipt of the apartment building as a part of the price. But he could

hardly say that his income from the apartment building, for all time to come or for any time, was deferred purchase money received from his sale.

The plaintiffs would, we suppose, distinguish the situation just described because, in the plaintiffs' case, Chicago as the owner of the working interest had agreed to do all of the operating and development and exploration work, and the plaintiffs had nothing to do but cash their royalty checks when, as and in whatever amounts they came in. But this is the situation of any owner of a royalty interest, and of any person who has income from bonds, notes, or stocks which pay dividends.

As to the controverted question of whether the plaintiffs' overriding royalties were, in 1941, reasonably susceptible of valuation, we have concluded that the question need not be answered. If, at the time the plaintiffs' capital gains were being computed for the 1941 transaction, the plaintiffs had sought a refund because the Government's valuation was too high, or the Government had assessed a deficiency because the plaintiffs' return showed too low a valuation, a court would have had to determine a valuation, or to decide that it was not possible to determine one. See *Burnet* v. *Logan*, 283 U.S. 404; *Philadelphia Park Amusement Co.* v. *United States*, 130 C. Cls. 166, 126 F. Supp. 184. If it did the latter, the further tax consequences would depend upon the nature of the interest found unsusceptible of valuation. If it was income producing property, such as the apartment house referred to above, the Government would get its revenue by taxing the income as received, and by taxing the capital gain when the building was next sold, since it would have a low cost basis. If the interest found unsusceptible of valuation was not a property interest, and therefore not capable of producing ordinary income which could be taxed as such, any further receipts from such an interest would be additional payments of purchase price, further capital gains from the sale, and taxable as such. If one, for example, promised to pay

$10,000 for a house, and to pay $5,000 more if he made a profit of $50,000 in a certain independent speculative venture in which he was engaged, the $5,000, if received, would be an addition to the sale price of the house, and taxable to the seller as capital gain. This was the situation in *Burnet* v. *Logan*, *supra*, and in *Haynes* v. *United States*, 100 C. Cls. 43, and *Tuttle* v. *United States*, 122 C. Cls. 1.

In the three cases just cited, the additional payments to be received were contingent upon the production of minerals from specified properties. The transactions did not, however, give to the contingent payee any property interest in the land or the minerals. None of the income from those properties was taxable to him as his income. He, of course, had a very lively "interest" in the fact that minerals should be produced from those properties, just as the man in the illustration above had an "interest" in the success of his purchaser's independent speculative venture.

It is apparent from what we have said that our view is that income received by an owner of a property interest is taxable to him as such, and that the fact that he received the property interest as a part of the sale price of property is irrelevant. The fact that the income is in large amounts only proves that he made a profitable deal when he accepted the property interest which later produced the income. The hope and belief that, by an exchange of money for property, or property for other property, income will be increased because the property received will produce more income than the money or property parted with, is the motive for most commercial transactions. To select one type of such transactions, as the plaintiffs would have us do, for special treatment would introduce confusion into an already difficult field of taxation

The plaintiffs' petitions will be dismissed.

It is so ordered.

MARIS, *Circuit Judge* (*Ret.*), sitting by designation, and WHITAKER, *Judge*, concur.

APPENDIX C

JONES, *Chief Judge*, dissenting:

I respectfully dissent from the conclusion reached by the majority. The findings of fact clearly show that there was an outright sale of the Corpus Christi stock to The Chicago Corporation; that payment was made partly in cash and partly in overriding royalties.

These royalties were wholly unlike the house or apartment rental illustration which is used in the majority opinion. The royalties were a part of the corpus of the property and were in no ordinary sense a payment for a use of the property. It is as if the purchaser of the house or apartment in question had sold a 1/20 interest each year until the entire house or apartment had been disposed of.

In other words, every barrel of oil that is taken out of the ground is a part of the property itself, and when the oil has been taken out of the property by the royalty, the entire ownership is gone.

Although there were several steps involved, the deal through which plaintiffs' stock in Corpus Christi was sold to Chicago, partly for cash and partly in return for the overriding oil and gas royalties, was in reality a single transaction. As I view it, the controlling point in these cases is the fact that the overriding royalties received by plaintiffs had no ascertainable fair market value at the time plaintiffs transferred their interests. In the many cases treating of oil and gas royalties for the purpose of deciding whether there has been a gain or loss under section 111 of the 1939 Internal Revenue Code for property sold or exchanged, it has always been held that the question of whether the royalties received by the taxpayer have an ascertainable fair market value is a question of fact. Where the factors affecting the valuation are so uncertain, contingent, or speculative that the value cannot be determined with reasonable accuracy, it must be held that the oil and gas interests have no fair market value. That is the situa-

tion here as found by the trial commissioner who heard and considered all the evidence bearing on the question. The reasons for this finding of lack of any market value at the time of the transfer are set out in findings 30, 31, and 32. For some reason the majority has seen fit to eliminate these findings.

I think these findings are vital and should be restored. They reveal the issue here to be very similar to that decided by the Supreme Court in *Burnet* v. *Logan*, 283 U.S. 404. The facts affecting the value of the overriding royalties in the instant cases contain more uncertain, unusual, and speculative elements than were present in other cases where it was held that the oil and gas interests considered had no ascertainable fair market value. *Edwards Drilling Co.* v. *Commissioner*, 35 B.T.A. 341; *Rocky Mountain Development Co.* v. *Commissioner*, 38 B.T.A. 1303. The facts before us show that the only petroleum product of any consequence recovered by Corpus Christi from the land up to the time plaintiffs' stocks were disposed of was wet gas. There was no market for the gas and the market for the distillate extracted therefrom was unstable and uncertain. Just prior to the closing of the transaction in suit, the only prospect held out to plaintiffs for recovering the money they had sunk in the venture was the revamping and enlarging of the recycling plant at an expenditure of $855,000 and by the drilling of additional oil wells. It was suggested that additional products could be recovered from the new plant but whether there would be a market for these and at what price was not known. Oil production was negligible and most of the property was unproven territory. The petroleum engineers who made the reports described in the findings pointed out the indefinite and unknown conditions existing in a considerable portion of the leased land and neither would hazard an estimate as to future oil production. As part of the price for plaintiffs' stocks, Chicago agreed to drill additional oil and gas wells.

but as shown in finding 9, this obligation was subject to contingencies which might never occur.

Added to the above, we have the undisputed showing that plaintiffs failed in their efforts to have several major oil companies place a value upon or make an offer for the properties. Not only were no offers forthcoming, but one major oil company with extensive holdings in the same general area advised plaintiffs to dispose of their interests as quickly as possible.

The taxing authorities placed a value of $1,035,000 on the interests of the minority stockholders, but this valuation was, of necessity, a pure estimate. There are formulas and equations available for estimating the value of almost any kind of property where the use of such methods is appropriate. But estimates do not meet the statutory test of "fair market value." If these words mean anything, they assume, first, the existence of a market for the particular property, and, second, the presence of sufficient facts to enable fair-minded men to determine the value in that market within the bounds of reasonable accuracy. If the next day or shortly thereafter it had been shown that only dry holes could be found, there is not the slightest doubt that the plaintiffs could have come back and shown the inaccuracy of the collector's estimate, and could have on that ground secured a deduction or a refund. In other words, these estimates are not necessarily final.

The facts in this record demonstrate that when plaintiffs' stocks were sold, the circumstances that would normally be relied upon to determine market value were shrouded in uncertainty and dependent upon the outcome of future developments. In the light of that record, I would adopt all the findings made by the trial commissioner and hold that since the overriding royalties had no ascertainable fair market value, the sale of plaintiffs' stocks resulted in an open transaction. On this basis, the payments received by plaintiffs from the sale of the oil and gas produced

from the land would be taxable as long-term capital gain because of the open transaction aspect, but no allowance would be made to plaintiffs for depletion. *Burnet* v. *Logan*, *supra*; *Commissioner* v. *Carter*, 170 F. 2d 941.

LARAMORE, *Judge*, joins in the foregoing dissenting opinion.

APPENDIX D

STATUTE INVOLVED

Internal Revenue Code of 1939:

"SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112.

* * * * *

"SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property, the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

* * * *

"SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

* * * *

(c) *Distributions in Liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall

be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112.

* * * *

"SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital Assets.*—The term 'capital assets' means property held by the taxpayer * * * [other than inventory and other assets not related here].

* * * *

(4) *Long-term Capital Gain.*—The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such gain is taken into account in computing gross income."

APPENDIX E

COMMISSIONER OF INTERNAL REVENUE v. CARTER

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT.

Nov. 29, 1948

Before L. HAND, *Chief Judge*, and SWAN and CHASE, *Circuit Judges*.

SWAN, *Circuit Judge*.

This appeal presents the question whether income received by the taxpayer in 1943 is taxable as long-term capital gain, as the Tax Court ruled, or as ordinary income as the Commissioner contends. The facts are not in dispute. The taxpayer, Mrs. Carter, had owned for ten years all the stock of a corporation which was dissolved on December 31, 1942. Upon its dissolution all of its assets were distributed to her in kind, subject to all its liabilities which she assumed. In the distribution she received property having a fair market value exceeding by about $20,000 the cost basis of her stock, and she reported such excess as a capital gain in her 1942 return and paid the tax thereon. In the corporate liquidation she also received 32 oil brokerage contracts which the parties stipulated had no ascertainable fair market value when distributed. Each contract provided for payment to the corporation of commissions on future deliveries of oil by a named seller to a named buyer. The contracts required no additional services to be performed by the corporation or its distributee, and the future commissions were conditioned on contingencies which made uncertain the amount and time of payment. In 1943 the taxpayer collected commissions of $34,992.20 under these contracts. She reported this sum as a long-term capital gain; the Commissioner determined it to be ordinary income. The Tax Court held it taxable as capital gain. The correctness of this decision

is the sole question presented by the Commissioner's appeal.

Mrs. Carter's stock was a "capital asset" as defined by section 117(a) of the Internal Revenue Code, 26 U.S.C.A. § 117(a). In exchange for her stock, she received the assets of the corporation upon its dissolution. The tax consequences of such a transaction are controlled by section 115(c), 26 U.S.C.A. § 115(c), which provides that "the gain or loss to the distributee resulting from such exchange" shall be determined under section 111, 26 U.S.C.A. § 111, but recognized only to the extent provided in section 112, 26 U.S.C.A. § 112. Turning to section 111(a): the "gain from the sale or other disposition of property" is the excess of "the amount realized therefrom" over the adjusted cost basis provided in section 113(b), 26 U.S.C.A. § 113(b). Paragraph (b) of section 111 defines the "amount realized from the sale or other disposition of property" to be the sum of money received "plus the fair market value of the property (other than money) received." Paragraph (c) of the same section provides that "In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112." That section lays down the general rule, subject to exceptions not pertinent to the case at bar, that "upon the sale or exchange of property" the entire amount of the gain or loss, determined under section 111, shall be recognized. From the foregoing statutory provisions, it is obvious that if the oil brokerage contracts distributed to the tax payer had then had a "fair market value", such value would have increased correspondingly the "amount realized" by her in exchange for her stock and would have been taxable as long-term capital gain, not as ordinary income. Boudreau v. Commissioner of Internal Revenue, 5 Cir., 134 F. 2d 360; Fleming v. Commissioner of Internal Revenue, 5 Cir., 153 F. 2d 361. The question presented by the present appeal is whether a different

result is required when contract obligations having no ascertainable fair market value are distributed in liquidation of a corporation and collections thereunder are made by the distributee in later years.

In answering this question in the negative, the Tax Court relied primarily upon Burnet v. Logan, 283 U.S. 404, 51 S. Ct. 550, 75 L. Ed. 1143. That involved a sale of stock, not a distribution in liquidation, under which the seller received cash and the buyer's promise to make future payments conditioned on contingencies. The cash received did not equal the seller's cost basis for the stock, and the contingencies affecting future payments precluded ascribing a fair market value to the buyer's promise. In later years payments were made which the seller did not return as income. The decision held that she was not required to do so. With respect to such payments, the court said, 283 U.S. at pages 412, 413, 51 S. Ct. at page 552.

"As annual payments on account of extracted ore come in, they can be readily apportioned first as return of capital and later as profit. * * * When the profit, if any, is actually realized, the taxpayer will be required to respond. The consideration for the sale was $2,200,000 in cash and the promise of future money payments wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty. The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one. Respondent might never recoup her capital investment from payments only conditionally promised. * * * She properly demanded the return of her capital investment before assessment of any taxable profit based on conjecture."

The Commissioner argues that the Logan case is inapplicable because there the taxpayer had not recovered the cost basis of her stock while here she had. The Tax Court thought the distinction immaterial. We agree. The Supreme Court spoke of the annual payments as constituting

"profit" after the seller's capital investment should be returned. Until such return it cannot be known whether gain or loss will result from a sale; thereafter it becomes certain that future payments will result in gain. No reason is apparent for taxing them as ordinary income. As this court said in Commissioner of Internal Revenue v. Hopkinson, 2 Cir., 126 F. 2d 406, 410, "payments received by the seller after his basis had been extinguished would have been taxable to him as capital gains from the sale of the property," citing Burnet v. Logan as authority.[1]

The Commissioner also urges that the Logan case is distinguishable because it dealt with a sale of stock rather than exchange of stock for assets distributed in a corporate liquidation. This contention is answered by White v. United States, 305 U.S. 281, 288, 59 S. Ct. 179, 83 L. Ed. 172, and Helvering v. Chester N. Weaver Co., 305 U.S. 293, 295, 59 S. Ct. 183, 83 L. Ed. 180, where the court held that the recognition required by section 115(c) of gains and losses on liquidations must for purposes of computation of the tax, be taken to be the same as that accorded to gains and losses on sales of property. Consequently we agree with the Tax Court's ruling that the principle of the Logan case is applicable to a corporate liquidation where stock is exchanged in part for contracts having no ascertainable market value, and that future collections under such contracts are taxable as capital gain in the year when received if the distributee has previously recovered the cost basis for the stock.

The Commissioner's argument that such collections are analogous to the receipt of interest or rent upon bonds or real estate distributed in a corporate liquidation overlooks a significant distinction. Payment of interest or rent does

[1] For similar rulings see Haynes v. United States, 50 F. Supp. 238, 100 Ct. Cl. 43; United States v. Yerger, D.C., 55 F. Supp. 521; Hill's Estate v. Maloney, D.C., 58 F. Supp. 164; Nicholson v. Commissioner of Internal Revenue, 3 T.C. 596.

not impair the value of the bond or real estate since each remains as a capital asset regardless of the number of payments. See Helvering v. Manhattan Life Ins. Co., 2 Cir., 71 F. 2d 292, 293. But with respect to the oil brokerage contracts, under which no additional services were to be rendered by the payee, each payment decreases their value until, with the final payment it will be completely exhausted; and, if the payments be treated as income, the distributee has no way to recoup his capital investment, since concededly he has no economic interest in the oil producing properties and therefore no right to depletion deductions.[2] Hence to consider the brokerage payments as ordinary income would produce a most unjust result and one quite unlike the result which follows the distribution of bonds or real estate in a corporate liquidation.

For the foregoing reasons we think the decision of the Tax Court correct. It is affirmed.

[2] It is true, in the case at bar, the taxpayer had no capital investment in the brokerage contracts because from other assets distributed she had already recovered the cost basis of her stock and the oil brokerage contracts had no ascertainable fair market value. But the Commissioner's analogy argument would be equally applicable if the brokerage contracts had been the only corporate assets distributed and if had been possible to ascribe to them a fair market value of $21,000. In that case, the distributee's capital investment in the brokerage contracts would have been $20,000, the cost basis of her stock being $1,000. She would be entitled to recover her capital investment before she could be charged with receiving either gain or ordinary income, and the only source of recovery would be the payments which would ultimately exhaust the value of the contracts. Hence the answer given above to the analogy argument is apposite.

APPENDIX F

WESTOVER ET AL. V. SMITH

UNITED STATES COURT OF APPEALS
NINTH CIRCUIT

Feb. 21, 1949

Before HEALY, BONE and ORR, *Circuit Judges.*

ORR, *Circuit Judge.*

This is an appeal from a decision of the district court holding that income received by Smith, the taxpayer, in 1941 and 1943 was taxable as capital gain rather than as ordinary income, and ordering a refund to the taxpayer of certain taxes erroneously collected.

The taxpayer was owner of all the stock of Quickwork Company, a corporation engaged in the manufacture and sale of machine tools. In 1940 Quickwork Company sold all of its assets to Whiting Corporation in exchange for cash and the right to receive 10% of the gross sales price of machinery to be manufactured and sold by Whiting Corporation, pursuant to patents theretofore held by Quickwork Company. Following this transaction Quickwork Company liquidated and dissolved. The distribution in liquidation netted the taxpayer $39,204.26 in cash and the assignment of the contract under which Whiting Corporation was required to make future royalty payments.

Since the adjusted basis of the taxpayer's stock on the date of liquidation was $34,000, she paid a capital gain tax on the $5,204.26 cash profit. While the contractual right she held had a very substantial value, there was, owing to future business contingencies, no way of ascertaining its fair market value. Thus, no value was assigned to it in the liquidation distribution. When payments were made by Whiting Corporation to the taxpayer in 1941 and 1943 under the contract, such payments were treated as ordinary income and income tax payments were made accord-

ingly. Taxpayer contends that the receipt of moneys from Whiting Corporation was an integral part of the liquidation distribution, and therefore such sums are to be treated as payments in exchange for stock under § 115(c) of the Internal Revenue Code, and taxed as a capital gain in the amount determined pursuant to § 111 of the Internal Revenue Code.[1]

Doubtless the value of the contract would be computed as a capital gain were it found to have an ascertainable market value at the time of Quickwork Company's liquidation. The taxpayer insists that the rule is the same in the present situation, where the value of the contract depends on uncertain future payments; that the transaction remains open until all payments are completed. Burnet v. Logan, 283 U. S. 404, 51 S. Ct. 550, 75 L. Ed. 1143, is cited. The Supreme Court of the United States, in that case, dealt with the sale of stock for cash plus a contractual

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[1] Relevant portions of the Code are as follows:

"§ 115. (c) Distributions in liquidation. Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111. * * *" 26 U.S.C.A. § 115(c).

"§ 111. Determination of amount of, and recognition, of gain or loss.

"(a) Computation of gain or loss. The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

"(b) Amount realized. The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received." 26 U.S.C.A. § 111(a, b).

right given by the purchaser to receive unascertainable amounts payable annually based on future production of iron ore. The cash consideration was less than the taxpayer's stock investment. It was held that the amounts received under the contract were not to be taxed until the taxpayer's capital investment had been paid off. The transaction was not a closed one because, as the Supreme Court of the United States said, "As annual payments on account of extracted ore come in they can be readily apportioned first as return of capital and later as profit."

Appellant seeks to distinguish the Logan case in that it involved a direct sale and not a corporate distribution, as here. It is pointed out that § 115(c) of the Internal Revenue Code states, "Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, * * *" and that in the instant case the taxable sums were not distributed in liquidation, but were paid because of the obligation of a third party. Hence, it is argued, the facts of this case do not permit the money received to be treated as a sale or exchange, which is the statutory foundation for the rule in Burnet v. Logan, supra. We do not agree.

As we have pointed out, if the contract in question had an ascertainable value, that amount would certainly be an "amount distributed in complete liquidation." The payments in this case arose directly out of the contract, which had a substantial value, and may be said to be "amounts distributed" within the purview of § 115(c), thus falling squarely within the holding in Burnet v. Logan, 283 U. S. 404, 51 S. Ct. 550, 75 L. Ed. 1143. Distributions under § 115(c) are treated in the same manner as sales. In any event, it is clear that the contract itself was a distribution under § 115(c). Its taxable valuation is its fair market value, according to § 111(b) of the Internal Revenue Code. Although there was no ascertainable fair market value at the time of liquidation, we find nothing in the statute

requiring the market value to be measured immediately. In such a situation the only practicable and accurate method of measuring the contract's value is through the application of money to such valuation as it is received. The alternatives are to ascribe a fictitious or speculative value to the property, which was condemned in the Logan case, or to allow it no value, as urged by appellants. Such methods result in inaccuracies and inequities. We think the proper procedure is to measure the value of the contract as payments are received.

In Commissioner v. Carter, 2 Cir., 170 F. 2d 911, a case which presents a factual situation almost identical with that of the instant case, the second circuit held that payments received under circumstances similar to payments made pursuant to the contract in question here should be taxed as capital gain. We think the payments in question here should be so treated and affirm the judgment.

Judgment affirmed.

APPENDIX G

These Cases Represent Decisions in Which the Open Transaction Doctrine Established in Burnet v. Logan, supra, Has Been Recognized.

Boudreau v. *Commissioner of Internal Revenue*, 45 BTA 390, (1941), Aff'd. 134 F. 2d 360 (CA-5, 1943).

Bradford v. *Commissioner of Internal Revenue*, 22 TC 1057 (1954).

Brown v. *Commissioner of Internal Revenue*, 26 BTA 781 (1932).

L. H. Burnet, Para. 56-210 P.-H. Memo. TC (1956).

Cluff v. *Commissioner of Internal Revenue*, 17 TC 225 (1951).

Columbia Oil & Gas Co. v. *Commissioner of Internal Revenue*, 41 BTA 38, Aff'd. 118 F. 2d 459 (CA-5, 1941).

Commissioner of Internal Revenue v. *R. J. Darnell, Inc.*, 18 BTA 125, Aff'd. 60 F. 2d 82 (CA-6, 1932).

Commissioner of Internal Revenue v. *Garber*, 50 F. 2d 588, (CA-9, 1931).

Commissioner of Internal Revenue v. *Moore*, 48 F. 2d 526 (CA-10, 1931).

Curtis v. *Commissioner of Internal Revenue*, 26 BTA 1103, (1932).

Dearing v. *Commissioner of Internal Revenue*, 36 BTA 845, (1937).

Deering v. *Commissioner of Internal Revenue*, 40 BTA 984, *Aff'd.* 102 F. 2d 91, (CA-5, 1939).

Dickey v. *Burnet*, 56 F. 2d 917 (CA-8, 1932).

Edwards Drilling Co. v. *Commissioner of Internal Revenue*, 35 BTA 341, Aff'd. 95 F. 2d 719 (CA-5, 1938).

Estate of Raymond T. Marshall, 20 TC 979 (1953).

Gatliff v. *Helburn*, 31 F. Supp. 495, D.C. E.D. Ky. (1940).

Gould Securities Co. v. *United States*, 96 F. 2d 780 (CA-2, 1938).

E. P. Greenwood v. *Commissioner of Internal Revenue*, 34 BTA 1209 (1936).

Helvering v. *Drier*, 79 F. 2d 501 (CA-4, 1935).

Helvering v. *Walbridge*, 70 F. 2d 683 (CA-2; 1934).
Hewitt v. *Commissioner of Internal Revenue*, 30 BTA 962 (1934).
Hobbs v. *Commissioner of Internal Revenue*, 26 BTA 241 (1932).
Hofferbert v. *Briggs*, 178 F. 2d 743 (CA-4, 1949).
Hopkinson v. *Commissioner of Internal Revenue*, 42 BTA 580, Aff'd. 126 F. 2d 406 (CA-2, 1942).
Lloyd v. *Commissioner of Internal Revenue*, 33 BTA 903 (1936).
Ludorff et al. v. *Commissioner of Internal Revenue*, 40 BTA 32 (1939).
Nicholson v. *Commissioner of Internal Revenue*, 3 TC 596 (1944).
North American Oil Consolidation v. *Burnet*, 286 U.S. 417 (1932).
O'Brien v. *Commissioner of Internal Revenue*, 25 TC 376 (1955).
O'Donnell v. *Commissioner of Internal Revenue*, 25 BTA 962 (1932); Aff'd. 64 F. 2d 634.
Peck v. *Commissioner of Internal Revenue*, Para. 52-203 P.-H. Memo. T.C.
Perry v. *Commissioner of Internal Revenue*, 152 F. 2d 183 (CA-8, 1945).
Potter v. *Commissioner of Internal Revenue*, Para. 48-529 P.-H. Memo. T.C.
Remer v. *Commissioner of Internal Revenue*, 28 T.C. 85, Aff'd. 260 F. 2d 337 (CA-8, 1958).
Reynolds v. *McMurray*, 60 F. 2d 843 (CA-10, 1932).
Rocky Mountain Development Co. v. *Commissioner of Internal Revenue*, 38 BTA 1303 (1938).
Shaffer v. *Commissioner of Internal Revenue*, 29 BTA 1315 (1934).
Smaltz v. *McCaughn*, 5 F. Supp 204 (E.D. Penn. 1933).
Speyer v. *Commissioner of Internal Revenue*, 30 BTA 517, Aff'd. 77 F. 2d 824 (CA-2, 1935).

Steinbach Kresge Co. v. Sturgess, 33 F. Supp. 897 (D.C. N.J. 1940).

Edward G. Swartz, Inc. v. Commissioner of Internal Revenue, 69 F. 2d 633 (CA 5, 1934).

United States v. Jones, 194 F. 2d 783 (CA-10, 1952).

Wells Amusement Co. v. Commissioner of Internal Revenue, 70 F. 2d 208 (CA-4, 1934).

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In the Supreme Court of the United States

OCTOBER TERM, 1959

No. 463

WILLIAM K. WARREN AND NATALIE O. WARREN, ET AL., PETITIONERS

v.

THE UNITED STATES

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinions in the Court of Claims (Pet. App. 2a–11a) are reported at 171 F. Supp. 846.

JURISDICTION

The judgment of the Court of Claims was entered on April 8, 1959 (Pet. 7a). A motion for rehearing was overruled on July 13, 1959 (Pet. App. 1). The petition for certiorari was filed on October 12, 1959. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

In 1941 the taxpayers received overriding royalty interests in oil and gas leases in connection with the

sale of their stock in, and the liquidation of, a corporation. In the taxable years 1949 through 1952 they received the royalty income which accrued to them under their overriding royalty interests. The question is whether the royalty income is taxable as ordinary income subject to an allowance for depletion, rather than as capital gain from the sale or liquidation of their stock interests.

STATEMENT

Prior to May 5, 1941, the Corpus Christi Corporation held oil and gas leases on 8,782 acres of land in three counties in Texas. Some eighteen producing wells were located on 2,200 acres of the property; the remainder was undeveloped. The corporation also owned and operated a high pressure cycling plant which had been constructed to extract the saleable distillate from the wet gas and reinject the dry gas into the earth (Pet. App. 2a).

Of Corpus Christi's 5,000 shares of stock, the Chicago Corporation owned 1,250 and the taxpayers owned the other 3,750 shares. Faced with a problem of financing the development of the property, the taxpayers sought to dispose of their stock in Corpus Christi (Pet. App. 2a). On May 5, 1941, they accepted an offer by the Chicago Corporation; under the terms of the offer, Chicago Corporation was to pay the selling shareholders, for sufficient shares to bring Chicago's holdings to 80% of the stock, $163.63 per share plus an additional amount of cash. The amount of such additional cash depended upon the tax treatment of the proposed liquidation of Corpus Christi.

In addition, Chicago agreed to cause Corpus Christi to convey to each shareholder who sold his stock to Chicago an overriding royalty interest, measured by a specified fraction per share of stock, in the oil, gas and other minerals in and under and to be produced from the Corpus Christi leases [1] (Pet. App. 2a–3a).

The sale of the Corpus Christi stock was accomplished in May 1941 and Corpus Christi was liquidated shortly thereafter. The Chicago Corporation paid the taxpayers the agreed amount of cash and caused Corpus Christi to convey the overriding royalty interests to the taxpayers under the terms of the conveyances. The conveyances of the overriding royalty interests to the taxpayers were similar in terms (with an exception not material to this case) to instruments generally used in the oil and gas industry for conveying overriding royalty interests (Pet. App. 3a).

In the taxpayers' income tax returns for 1941, the year in which they sold their Corpus Christi stock and acquired the overriding royalty interests, they reported as long-term capital gain the excess of the cash paid to them by Chicago over what their Corpus Christi stock had cost them. They did not include in their capital gain any value for the overriding royalty interests which they received in the transaction, stating that those interests had no ascertainable market value. The Commissioner, however, placed a value of $1,035,000 upon the interests of all the

[1] In the oil and gas industry the term overriding royalty interest means a fraction of the working interest which by agreement is relieved of the expenses of development and production (Pet. App. 3a).

minority stockholders, and added proportionate parts of that amount to the capital gains of the taxpayers. The taxpayers paid taxes on these additional amounts of capital gain (Pet. App. 3a–4a).

For the taxable years 1949 through 1952, the years involved here, the taxpayers included in their returns their receipts from their overriding royalty interests as ordinary income and deducted the statutory 27½ percent depletion allowance. So far as appears, they had also treated their income similarly for the years 1941 through 1948. For the years 1949 through 1952 they filed timely claims for refund on the ground that the receipts from their overriding royalty interests were additional amounts received by them as part of the purchase price of the Corpus Christi stock which they sold to Chicago in 1941 and should therefore be taxed at capital gain rates (Pet. App. 4a).

The Court of Claims, with two judges dissenting, held that the plaintiffs were not entitled to have their receipts from their overriding royalty interests taxed at capital gain rates, regardless of whether in 1941, when the overriding royalty interests were received, such interests had an ascertainable fair market value (Pet. App. 4a–11a).

ARGUMENT

No basis for certiorari is presented. The narrow, technical issues involved lack general importance; there is no conflict of decisions; and, on the merits, the decision below is correct.

1. The taxpayers' royalty income is not taxable as capital gain; it was not derived from a capital transaction. The 1941 transaction, under which they received cash and overriding royalty interests for their

stock, was a closed transaction in 1941. That the value of the royalty interests may not have been subject to accurate estimate did not alter the character either of the transaction or of what the taxpayers received. And, as this Court has held, such royalty interests are property interests in the oil and gas in place. See, *e.g.*, *Palmer* v. *Bender*, 287 U.S. 551; *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25. The income from oil and gas royalty interests is taxable as ordinary income, subject to a depletion allowance, rather than as capital gain. *Burnet* v. *Harmel*, 287 U.S. 103; *Palmer* v. *Bender*, *supra*; *Burton-Sutton Oil Co.* v. *Commissioner*, *supra*; *Anderson* v. *Helvering*, 310 U.S. 404; *Commissioner* v. *Southwest Expl. Co.*, 350 U.S. 308.

No exception from the general principle can be justified here on the ground that the royalty interests were received in exchange for other property and are a type of property or asset which was later *pro tanto* exhausted as the oil was taken out of the ground. Indeed, it is precisely because the owners of royalty interests are deemed to have an ownership, or capital, interest in the oil and gas in place that they are entitled to a depletion deduction, and that deduction, allowed concurrently with the extraction of the oil, compensates for the attendant loss in relation to the property or capital interest as such. See, *e.g.*, *Parsons* v. *Smith*, 359 U.S. 215.

2. The decision below involves no conflict with *Burnet* v. *Logan*, 283 U.S. 404. In that case the taxpayer, Edith Logan, owned stock in Andrews & Hitchcock Iron Company which in turn owned stock in Mahoning Ore and Steel Company. The latter

corporation owned a mining lease and by agreement among its stockholders apportioned ore among its stockholders according to their holdings. In 1916, Edith Logan and the other stockholders sold their stock in Hitchcock Iron Company to Youngstown Sheet and Tube Company which thereupon acquired the right to receive a portion of the mining production by Mahoning Ore and Steel Company. For this stock Youngstown paid cash and agreed to pay annually thereafter a sum equal to 60 cents for each ton of ore to which it became entitled by virtue of its stockholding in Mahoning. The Internal Revenue Service sought to tax to Edith Logan as gain in 1916 the cash plus the estimated value of the contract calling for subsequent payments. This Court held that the value of the contract could not be accurately estimated; that, consequently, the transaction could not be closed in 1916; that Edith Logan should pay no tax on income until she recovered a sum equal to the basis for her stock, and that thereafter she should report the subsequent payments as received.

Thus, *Burnet v. Logan* did not involve income derived from the operation of a mine. The Court was careful to point out (283 U.S., at p. 412) that it was "not dealing with royalties or deductions from gross income because of depletion of mining property."[2] The case dealt merely with the collections of subsequent payments in discharge of the purchase price

[2] Other courts have pointed out that the case has nothing to do with royalties or other income from the operation of mineral leases. *Smaltz* v. *McCaughn*, 5 F. Supp. 204, 205 (E.D. Pa.); *Commissioner* v. *J. A. O'Shaughnessy, Inc.*, 124 F. 2d 33 (C.A. 10th).

of property. Such payments were measured by production but were made in discharge of a personal covenant or obligation. Edith Logan was not the owner of a property interest in the mines. Her contract was with Youngstown, which had no interest in the mines. Thus, the instant case is readily distinguishable.

This distinction between gross income derived from an interest in minerals in place and collection of contingent installment payments was carefully observed in all the cases involving oil and gas transactions which are cited in Appendix G to the taxpayers' petition (Pet. App. 23a–25a). In those cases the courts held that *Burnet* v. *Logan, supra,* and the so-called open transaction doctrine were not applicable to income derived from the operation of oil and gas wells. In some of the cases[3] it was found that the taxpayer owned an economic or property interest in the oil and gas in place and was taxable on his royalty or oil payment income as ordinary income subject to the allowance for depletion. In other cases[4] it was found that the tax-

[3] *Columbia Oil & Gas Co.* v. *Commissioner*, 41 B.T.A. 38, 47–48, affirmed, 118 F. 2d 459 (C.A. 5th); *Dearing* v. *Commissioner*, 36 B.T.A. 843, affirmed, 102 F. 2d 91 (C.A. 5th) (value of oil payment there involved not ascertainable) *Gatliff* v. *Helburn*, 31 F. Supp. 495 (E.D. Ky.); *Reynolds* v. *McMurray*, 60 F. 2d 843 (C.A. 10th); *Smaltz* v. *McCaughn*, 5 F. Supp. 204 (E.D. Pa); *Boudreau* v. *Commissioner*, 134 F. 2d 360 (C.A. 5th) (value of the mineral interest fixed by the court).

[4] *Commissioner* v. *Garber*, 50 F. 2d 588 (C.A. 9th); *Edwards Drilling Co.* v. *Commissioner*, 35 B.T.A. 341, affirmed, 95 F. 2d 719 (C.A. 5th) (Board of Tax Appeals' opinion found contracts had a stated fair market value); *Commissioner* v. *Moore*, 48 F. 2d 526 (C.A. 10th), certiorari denied, 284 U.S. 620; *Hobbs* v. *Commissioner*, 26 B.T.A. 241; [illegible]*lson* v. *Commissioner*, 3 T.C. 596; *O'Donnell* v. *Commissioner*, 25 B.T.A. 956, affirmed,

payer was entitled to, or received, contingent payments measured by the product of oil and gas or other minerals, but had no economic or other property interest in the minerals in place. The other cited cases contain references to *Burnet* v. *Logan, supra,* but do not involve oil and gas or other mineral transactions and are irrelevant here.

3. The decision below is not in conflict with *Commissioner* v. *Carter,* 170 F. 2d 911 (C.A. 2d), and *Westover* v. *Smith,* 173 F. 2d 90 (C.A. 9th). Those cases involved the liquidation and collection of property in the form of contingent promises to pay money, whereas the present case involves the taxation of income produced from property owned by the taxpayers.

In *Commissioner* v. *Carter, supra,* the taxpayer, upon dissolution of a corporation, received all of its assets in surrender of her stock. Among the assets were 32 oil brokerage contracts which, it was stipulated, had no ascertainable fair market value. Each contract provided for payment to the corporation of commission on future deliveries of oil by a named seller to a named buyer. The contracts required no additional services to be performed by the payee and were subject to contingencies which made uncertain the amount and time of payment. The court held that collections under the contracts were taxable as

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64 F. 2d 634 (C.A. 9th), certiorari denied, 290 U.S. 699; *Reimer* v. *Commissioner,* 28 T.C. 85, affirmed, 260 F. 2d 337 (C.A. 8th); *Rocky Mountain Development Co.* v. *Commissioner,* 38 B.T.A. 1303. In *Boudreau* v. *Commissioner,* 134 F. 2d 360 (C.A. 5th), the value of the royalty interests was fixed and the tax was computed accordingly.

capital gain, reasoning that each payment decreased the value of the contracts, which would be exhausted with the final payment, and that, if the payments were treated as income, the distributee had no way to recoup his capital. The court distinguished this situation from cases (like the present one) where property, such as bonds and real estate, produces income, and pointed out (p. 913) that the taxpayer in that case had "no economic interest in the oil producing properties and therefore no right to depletion deductions."

Westover v. *Smith*, *supra*, is similar. There the taxpayer upon liquidation of a corporation, Quickwork Company, acquired a contract which entitled him to ten percent of the gross sales price of machinery to be manufactured and sold by Whiting Corporation, to which Quickwork Company had sold some patents. Owing to future business contingencies, there was no way of ascertaining its fair market value. The court held that collections under the contract should be treated as payments in exchange for the stock and taxed as capital gain.

Carter and *Westover*, *supra*, are therefore cases which, because of their facts, were held to warrant the application of an exception to the general rule which is inapplicable to the present case. Here the property involved is not just a contractual right to receive money in the future; it is an interest in real property. And, because of the difference in the type of property involved, the taxpayers' capital, represented by the value of the property in 1941 (in what-

ever amount) is recouped through the depletion allowance.[8]

CONCLUSION

The petition for certiorari should be denied.

Respectfully submitted.

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NOVEMBER 1959.

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[8] *Hoy* v. *Commissioner*, decided February 25, 1958 (1958 P-H T.C. Memorandum Decisions, par. 58,028), also relied upon by taxpayers (Pet. 7-9), is similar to the *Carter* and *Westover* cases. Rev. Rul. 58-402, 1958-2 Cum. Bull. 15, cited by the taxpayers for the proposition that the "open transaction doctrine" is well recognized by the Commissioner (Pet. 10), states the rule of the *Carter* and *Westover* cases—that contingent contracts may be subject to capital gain treatment—but emphasizes that it is only in rare and extraordinary cases that property will be treated as having no ascertainable market value. The ruling has no bearing on the manner in which income from income producing property is to be taxed, and especially not to oil and gas interests where the exact value of the property (or capital investment) is completely immaterial in computing the depletion allowance through which that value (or capital investment) is recovered.

U. S. GOVERNMENT PRINTING OFFICE 1959

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JAMES R. BROWNING, Clerk

IN THE

Supreme Court of the United States

OCTOBER TERM, 1959

No. 463

WILLIAM K. WARREN and NATALIE O. WARREN, ET. AL.,
Petitioners,

v.

THE UNITED STATES, *Respondent.*

PETITIONER'S REPLY

By the Government's Own Admission the Warren Case Is Within the Ambit of the Logan Case.

The Government's statement on page 5 of the Brief in Opposition that the value of the royalty interest may not have been subject to "accurate estimate", taken with what is said on page 6 of its Brief that the value of the contract could not be "accurately estimated" shows that the two cases are parallel for the application of the *open transaction doctrine.*

The inaccuracy in the *Warren* case is disclosed by the fact that the tax authorities placed a value of $1,035,000

as of July 1, 1941 whereas, by the end of 1956, the plaintiffs had received $11,548,107.84. See Petition, Appendix B, p. 5a.

It is hard to conceive stronger proof to support the action of the petitioners in not including in their 1941 and subsequent years any value for the overriding royalty interest, *stating in their return that those interests had no ascertainable fair market value.* If taxation is a practical matter, where could one find a better case for the application of the *open-transaction doctrine* discussed on page 10 of Petitioner's Brief.

Respectfully submitted,

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